Testimony
Before
Subcommittee on General Farm Commodities and Risk Management
United States House of Representatives Committee on Agriculture
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By

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and
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Although I endeavor to be objective in my testimony, in the interests of full disclosure, I should note for the Subcommittee that my wife and I through an entity, Harl Farms, LLC, own farmland in Iowa which is operated under livestock-share and crop-share leases. I am in emeritus status from Iowa State University and continue to be engaged in writing, publishing and consulting. I do not believe that my testimony is affected in the slightest by any of those activities, however.

I. Introduction

The agricultural sector is not an economic island. However, the global financial difficulties that have caused severe heartburn for financial firms and most of the global economy have largely bypassed the agricultural sector. It is clear that the longer the meltdown persists *the more serious and far-reaching the effects are likely to be on farming and ranching and on rural areas.* If investor confidence is not soon restored, credit availability could pose a significant problem for production credit, land purchases and trade in agricultural products and the world-wide demand for agricultural products would likely decline further. Moreover, rural areas have suffered lay-offs with rising unemployment, stock market losses and reduced discretionary spending in addition to the long-term adjustments that have been on-going for decades. These effects seem likely to continue for the next several quarters and, in some instances, beyond. Farming, particularly crop farming, has fared relatively better than livestock farming in recent months but storm signals are flying for crop production.

II. The Danger Signals

Higher commodity prices in 2007 and 2008 and modest debt levels (compared to the 1980s era) have helped the farming sector in many areas of the country avoid the worst effects of the global meltdown and have enabled agricultural lenders, in general, to maintain healthy balance sheets. But the sharp declines in commodity prices in late 2008, the economic and financial woes of the ethanol industry and the falling demand for agricultural products, especially in developing countries, are impacting the sector to a much greater extent in 2009.

Commodity demand and supply

When corn prices were hovering near $8 per bushel, soybeans were selling at more than $15 per bushel and wheat had skyrocketed to near $25 per bushel in some specialty wheat markets, optimism was justified for those who believed that such price levels would continue. An unprecedented amount of net income was bid into cash rents and capitalized into land values. But with corn dropping to the vicinity of $4 per bushel, soybeans in the $9 to $10 per bushel range and wheat declining to $5 to $6 per bushel, there is less income to capitalize into land values. Moreover, production costs have risen, almost across the board, cutting into the net income per acre. Granted, the sharp drop in crude oil price in recent months has provided some relief on the cost front with the impact going well beyond the costs for gasoline and diesel fuel. One sobering factor on the demand side (particularly on the commodity futures markets) has been the role played in futures prices by the commodity funds. While the role of the funds in the steep run-up in crude oil prices is now fairly well established, the role of the investment funds in the dramatic climb of agricultural commodity prices (and subsequent declines) is less well accepted. Suffice it to say, it may not have been all demand and supply in the traditional sense.

As a consequence of several factors, mostly related to demand, farmland values declined in late 2008 and are expected to decline further in 2009 and, possibly, in 2010. Long-term, land prices are influenced by the net income from the farm commodities produced on the land in question. While a replay of land value declines in the 1980s is not anticipated, any decline affects credit availability, especially for the more heavily leveraged prospective purchasers.

Ethanol production

The boost in commodity prices was heavily related to the growth of the ethanol industry. The demand of ethanol plants for corn caused a run-up in the prices for other commodities competing for farmland, notably soybeans and, to a lesser degree, wheat. As of early 2009, approximately 170 ethanol plants were in production, representing roughly four billion bushels of demand for corn.

That demand appears less secure in light of the economic problems faced by the ethanol industry. More than 20 ethanol plants have filed for bankruptcy in recent months and several more have ceased operations for various financial and economic reasons. By some estimates, as much as 30 percent of ethanol capacity is idled or on slowdown.

The economic trauma in some instances has been partly the result of factors affecting all ethanol plants; in other situations, the economic hurdles have been more severe for recently-constructed plants. Dramatic fluctuations in the price of corn (the major input) and in the price of crude oil (which has a considerable influence on the price for ethanol) have wrenched the industry well beyond anything that could possibly have been anticipated by investors in ethanol plants. These are the two "brakes" that are faced by the ethanol industry. The steep rise in construction costs has contributed to the economic problems, also.

Several plants have been shuttered or are in bankruptcy because of ill-fated steps taken to manage risk with the hedges resulting in huge losses as the price of corn rose to record levels and then declined sharply to more normal levels.

The future of the ethanol industry depends heavily upon three factors—(1) the energy policy of the United States (which has been friendly to ethanol for several years); (2) the economics of conversion of feedstock (principally corn) into ethanol fuel; and (3) the emerging technologies and their competitive positions. Ethanol is likely to merit a "place in the sun" for three to five more years. Beyond that, ethanol may well rank as a component of the package of alternative energy sources for some time in the future. Economic considerations will almost certainly be the major determinants as to which energy alternatives survive as energy sources. The energy source that can produce the units of energy needed at the lowest price and with the safety factors and reliability factors demanded by consumers will be in the driver's seat.

As for ethanol plants that are now shuttered or cannot cover their variable costs, some are likely to be sold at a discount (currently, variable costs are roughly 90 percent of the cost of producing ethanol, leaving little for fixed costs and profit for investors). A government credit line would help to buy time but is not a viable long-term solution. In the long-term, ethanol must be a competitive source of energy to survive unless subsidies continue, mandates increase and tariffs are maintained.

<u>Impact of the meltdown on the demand for food and fiber</u>

In recent years, the gradual increase in per capital incomes around the world, but particularly in the low-income countries, caused a steady increase in the demand for food. The income elasticity of demand for food is high in those countries (as high as 0.7 which means that 70 percent of additional income goes for food). The increase in per capital incomes was heavily related to trade, outsourcing and globalization, with production gradually moving to areas of lowest cost production and with all manner of economic activities shifting to low wage countries, raising per capita incomes.

All of that has been affected by the global meltdown in recent months with the demand for the goods and service produced in those countries declining, in some instances dramatically. This is leading to reduced demand for food, worldwide. Most of the leading importers of farm commodities from the United States have reduced imports except for China. The rising unemployment in China will likely lead to reduced demands for food in that country as the world-wide demand for the labor intensive products produced in that country slips. The World Trade Organization is predicting a nine percent decline in world trade this year.

<u>Signs of tightening credit</u>

Depending upon how long the economic crisis persists and how deep the trauma becomes, it will clearly affect credit availability at all levels. Denial of credit in the short-run results in economic pain and the disposal of assets serving as collateral which affects asset values in the markets. Those with weak balance sheets (high debt-to-asset ratios) generally suffer the greatest. The relatively thin band of equity capital on the part of lenders makes the lenders particularly vulnerable.

As an example, as of December 31, 2008, the Federal Deposit Insurance Corporation (FDIC) reported that as of the end of the fourth quarter of 2008, 6.93 percent of Iowa banks were unprofitable compared to 4.3 percent in the fourth quarter of 2007 and 2.87 percent in 2006. About half of the banks reported non-performing loans above one percent at the end of 2008. Although agriculture is a major part of the Iowa economy, these data do not appear to reflect weakness of the agricultural economy so much as weakness in the general economy. Agricultural banks in recent months have had a much stronger performance than similarily-sized commercial banks. However, with lower commodity prices and higher costs of production in prospect, the agricultural economy may be a greater contributor to lender problems going forward.

III. Conclusion

The economic state of the agricultural sector (both farms and ranches and rural areas generally) depends heavily on whether the world economy continues to decline. If confidence is not restored, and the financial systems continue to deteriorate, the agricultural sector will likely suffer the effects on a widespread basis. The success of the stimulus packages and the efforts to stabilize the world's financial institutions are vitally important to the agricultural sector.

My biggest concern is that the global meltdown that is being experienced has not displayed the features of a normal economic decline. The drop in economic activity that began in late 2007 appears to be more of a "downshifting" of the economy, due principally to a revolutionary shift in thinking by consumers about debt, the likely result of companies curtailing the use of high levels of debt and the corralling of patently unwise strategies employed on a widespread basis to deal with risk. Consumers, companies and governments have all been living beyond their means. That bubble has now burst. Adjustments in economic activity promise to be profound and far-reaching as the world's economy comes to reflect a more cautious use of debt at all levels, at least for the foreseeable future. That is likely to affect the buoyancy of the general economy for several years.

Neil E. Harl

Neil E. Harl is Charles F. Curtiss Distinguished Professor in Agriculture and Emeritus Professor of Economics at Iowa State University, Ames, Iowa. He is a member of the Iowa Bar. Dr. Harl was Director of the Center for International Agricultural Finance from 1990 through 2004. He received a B.S. from Iowa State University in 1955, a J.D. from the University of Iowa in 1961 and a Ph.D. in economics from Iowa State University in 1965. He was named a distinguished professor in 1976. His major fields of interest include estate planning, business planning, taxation, agricultural law, agricultural finance and resource economics.

Dr. Harl has published widely including 28 books; more than 400 professional articles and bulletins; and more than 850 articles in farm and financial publications. He is author of the 15-volume treatise, *Agricultural Law*, the single volume *Agricultural Law Manual* and the two-volume *Farm Income Tax Manual*; co-author of three Tax Management Portfolios—*The Family-Owned Business Deduction, Reporting Farm Income* and *Taxation of Cooperatives* and co-author of *Principles of Agricultural Law*. He is also author of *The Farm Debt Crisis of the 1980s* (Iowa State University Press, 1990). Dr. Harl has spoken widely with more than 3200 speaking appearances in 43 states and 17 foreign countries.

He has received more than 30 major awards including the USDA Superior Service Award in 1987; the President's Award from the Iowa State Bar Association in 1991; Charles A. Black Award from the Council for Agricultural Science and Technology in 1997, for effectiveness in communicating with the public; the Distinguished Service to Agriculture Award from the Chicago Farmers Club in 1999; the *Wallaces Farmer* Iowa Master Farmer Award for Exceptional Service to Agriculture in 2000; the Speaker of the Year Award by the National Society of Accountants in 2000; the Presidential Service Award from Iowa State University in 2002; and the Service to American and World Agriculture Award from the National Association of County Agricultural Agents in 2006.

Dr. Harl has served on six federal advisory bodies -- a Farm Tax Reform Task Force for the U.S. Department of the Treasury in 1967; the Commissioner's Advisory Group (Commissioner of Internal Revenue) in 1979-80; the USDA Farm Structure Task Force in 1980; the Office of Technology Assessment, Technical Advisory Committee, by Congressional Appointment, 1987-1995 (chair in 1993-94); the USDA Advisory Committee on Agricultural Biotechnology, 2000-2002; and the Commission on Federal Payment Limitations in Agriculture, 2002-2003.

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Committee on Agriculture
U.S. House of Representatives
Required Witness Disclosure Form

House Rules* require nongovernmental witnesses to disclose the amount and source of Federal grants received since October 1, 2004.

Name: Neil E. Harl

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Organization you represent (if any): NONE

1. **Please list any federal grants or contracts (including subgrants and subcontracts) <u>you</u> have received since October 1, 2004, as well as the source and the amount of each grant or contract. House Rules do <u>NOT</u> require disclosure of federal payments to individuals, such as Social Security or Medicare benefits, farm program payments, or assistance to agricultural producers:**

Source: NONE **Amount:**

Source: **Amount:**

2. **If you are appearing on behalf of an organization, please list any federal grants or contracts (including subgrants and subcontracts) <u>the organization</u> has received since October 1, 2004, as well as the source and the amount of each grant or contract:**

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Please check here if this form is NOT applicable to you:

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